Government bond yields surge to multi-year highs amid inflation and energy price concerns, offering opportunities in quality short- and medium-duration bonds. (UBS)

Will government bond markets recover their poise?

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While equity markets have recently seemed relatively relaxed about the potential economic harm from the US-Iran conflict, the same cannot be said of the government bond market.

Government bond yields hit multi-decade highs early last week, as investors fretted that a sustained period of high energy prices could force central banks to tighten monetary policy to see off inflation. The 30-year US Treasury yield hit its highest level since 2007, while long-dated bonds in Germany, the UK, and Japan rose to multi-year highs. As of late last week, market pricing of the probability of a Federal Reserve hike by December had risen to 82%, its highest level so far this year. While that looks unlikely to us, risks of more hawkish policy have increased. We have therefore raised our year-end forecasts for 10-year yields in the US, Germany, UK, and Japan.

But yields did retreat from recent peaks later last week and investors will be hoping for further signs that the worst is over. Much will depend on whether there is clearer progress toward peace in the Middle East. Signals have remained mixed, with further US-Israeli strikes on Iranian vessels coming alongside optimistic messages from both sides that talks have made progress. After various setbacks, investors will be eager for an agreement that will ease concerns about energy prices, inflation, and central bank tightening. With inflation concerns on the rise, markets will also be looking to April's US Personal Consumption Expenditures price index, the Fed's favorite gauge, for guidance on whether underlying inflation pressures are broadening beyond energy and goods. Comments from top officials at the Fed, the European Central Bank, and the Bank of England will also help shape the debate over how central banks might respond to the stagflationary risks.

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In our view, higher energy prices are likely to contribute to tighter central bank policies, delaying a Fed cut until the end of the year and encouraging the ECB to raise rates twice this year. We also continue to see longer-duration bonds as vulnerable to both fiscal and inflation risks. However, we think markets have gone too far in pricing renewed rate-hiking cycles. We still see a high bar for a Fed hike, with wage growth moderating and inflation expectations broadly anchored. Our base case remains for the Fed to cut in December and again in March. Against this backdrop, we believe the recent sell-off offers an opportunity to lock in attractive yields in quality short- and medium-duration bonds.

Original report – **Weekly Global: What to watch in the week ahead, 26 May 2026.**

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